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JOHN F. DAVIS,

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

Nos. 779 and 836

NORFOLK AND WESTERN RAILWAY COMPANY,
Appellant

v.

UNITED STATES OF AMERICA, ET AL.,
Appellees

JOHN HANCOCK MUTUAL LIFE INSURANCE COMPANY, ET AL.,
Appellants

v.

UNITED STATES OF AMERICA, ET AL.,
Appellees

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

MOTION TO AFFIRM IN NOS. 779 AND 836 BY ERIE-LACKAWANNA RAILROAD COMPANY

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NORFOLK AND WESTERN RAILWAY COMPANY, *Appellant*, *v.* UNITED STATES OF AMERICA, *et al.*, *Appellees.*	No. 779
JOHN HANCOCK MUTUAL LIFE INSURANCE COMPANY, *et al.*, *Appellants*, *v.* UNITED STATES OF AMERICA, *et al.*, *Appellees.*	No. 836

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

MOTION TO AFFIRM IN NOS. 779 AND 836 BY ERIE-LACKAWANNA RAILROAD COMPANY

Appellee, Erie-Lackawanna Railroad Company (EL), moves to affirm the judgment of the district court in so far as it is challenged by the appeals of Norfolk and Western Railway Company (N&W) in No. 779 and of John Hancock Mutual Life Insurance Company, *et al.* (the EL Bondholders) in No. 836. Those appeals are taken from that portion of the final judgment of the three-judge court for the Southern District of New York entered on October 19, 1967, dismissing appellants' complaints. Their com-

plaints sought to enjoin and set aside an order of the Interstate Commerce Commission (the Commission) directing N&W to include EL, The Delaware and Hudson Railroad Corporation (D&H) and Boston and Maine Corporation (B&M) upon specified terms (the *Inclusion* case). The questions presented by those appeals are so unsubstantial as not to need further argument.

STATEMENT

Almost seven years ago EL first sought inclusion in the system which N&W was then seeking to create, and has since created, by its merger with The New York, Chicago and St. Louis Railroad Company (NKP), lease of the Wabash Railroad Company (Wabash) and other related transactions.* The Commission authorized those transactions on June 24, 1964. 324 I. C. C. 1. The N&W system was thus enabled to achieve $29 million of annual operating savings and to obtain more than $50 million of additional annual operating revenue. 330 I. C. C. 780, 801, 881.

At the outset of those proceedings, EL intervened in opposition to the proposed consolidation unless, pursuant to section 5(2)(d) of the Interstate Commerce Act, it were included as a part of the new system. However, on October 30, 1961, EL withdrew its opposition and its petition for inclusion pursuant to an agreement with N&W. 324 I. C. C. at 20-21. That agreement provided, among other things, that, after the merger of N&W and NKP was authorized, N&W would "forthwith, in good faith" enter into negotiations with EL in an attempt to agree upon a plan for some

*A fuller statement of the prior proceedings is set forth in our brief to the court below in the *Inclusion* case dated September 25, 1967, and furnished to the Court pursuant to its order of November 9, 1967. In supplementing this presentation we shall refer to that brief as "EL Brief Below."

form of inclusion of EL in the enlarged N&W system. Ex. EL-1, at 3.*

To allow full exploitation of that agreement "and to afford the fullest protection to the public interest," 324 I. C. C. at 28, the Commission, pursuant to its authority under section 5(2)(d) to require, "upon equitable terms, inclusion of another railroad or other railroads in the territory involved," conditioned its approval of the N&W-NKP-Wabash unification upon the following provisions in Appendix O to its report:

> "1. For a period of 5 years following the date of the order herein the Commission will retain jurisdiction to permit the filing of petitions by the Erie-Lackawanna Railroad Company, The Delaware and Hudson Railroad Corporation, and the Boston and Maine Railroad for inclusion in the Norfolk & Western system. Upon the filing of such petition or petitions, the attendant facts and circumstances will be appraised upon the basis of an appropriate record or records then to be compiled, and if the affiliation or affiliations then sought, or some reasonable modification thereof, be found consistent with the public interest, the Commission will direct the accomplishment thereof under such terms as may be found equitable to all parties involved. It is not intended that acceptance of this condition by applicants herein will foreclose or limit review of any decision of the Commission disposing of a petition filed pursuant to this condition.

*The statements and exhibits offered by EL and N&W were identified in different ways. For convenience, all citations to prepared statements will include the name of the witness. EL statements will be cited with the number preceded by an "S". All other documents marked as exhibits, including N&W statements, will be cited with the number preceded by "Ex." All references to pages of the transcript of the hearings will be preceded by "Tr."

"2. . . .

"3. Consummation by the applicants of any transaction approved herein shall constitute on the part of such applicants acquiescence in and irrevocable assent to the conditions stated in this appendix." 324 I. C. C. at 148.

Thus, by consummating the merger with NKP and the related transactions, N&W irrevocably assented to the conditions in Appendix O and became obligated under its contract with EL.

N&W was aware of the advantages and disadvantages of an affiliation with EL when it entered into the agreement with EL and when it irrevocably assented to the conditions of Appendix O. Tr. 1313-14 [Fishwick, N&W Senior Vice President]; EL S-4, Moonshower, at 1-3. However, despite the efforts of EL to negotiate with N&W after the NKP merger, N&W simply refused to enter into any meaningful discussions with EL. EL S-1, Fuller at 15-18; Tr. 1310-11 [Fishwick].

Because of EL's dramatically improving financial condition, EL had every reason to believe that a satisfactory form of affiliation with N&W could be agreed to. That turnaround was characterized by an outstanding railroad expert as "one of the most sensational rehabilitations of railroad earning power ever accomplished in this country," and that judgment was adopted by the Commission. 330 I. C. C. at 812-13. The reasons for that turnaround, engineered by new management obtained by EL in mid-1963, are set forth at length in the testimony submitted by EL, EL S-2, Maxwell, at 3-9, 13-36; EL S-7, Wyer, at 7-29, and in the Commission's report. 330 I. C. C. at 843-44. A summary of the

basic financial results involved demonstrates that turnaround.*

	1961	1963	1964	1965	1966	1965-66 Average
Railway Operating Revenues	$211.0	$206.0	$212.4	$230.0	$235.8	$232.9
Railway Operating Expenses	192.2	180.8	179.8	185.0	185.3	185.2
Income Available for Fixed Charges	(13.9)	(7.5)	1.7	14.7	18.5	16.6
Net Income after All Charges ...	(26.5)	(17.1)	(8.3)	3.3	6.7	5.0†

Source: 330 I. C. C. at 873 (all figures in millions).

However, all chance of negotiating an affiliation with N&W disappeared when, on August 31, 1965, N&W revealed to the public that it had negotiated a merger with The Chesapeake & Ohio Railway Company (C&O). EL S-1, Fuller, at 17-18. The projected N&W-C&O merger included a proposal—the so-called Dereco plan—to accept EL and four other smaller eastern railroads as subsidiaries

*The record was closed August 10, 1966. The Commission's decision dated June 9, 1967, considered all financial reports through the first quarter of 1967. 330 I. C. C. at 811-12 n.18. N&W repeatedly urges on the Court the more recent financial reports which were obviously not considered by the Commission. Those financial reports, like the reports of the other railroads in the eastern district and most of the railroads throughout the country, show a revenue decline for the first nine months of this year. They neither prove nor disprove the correctness of the Commission's projection. Nor is there any way of evaluating the significance of those reported figures from the record.

†The major adjustment made by the Commission in estimating EL's future contribution to the N&W system was to add to EL's average reported results during 1965-66 $4.5 million ($6.8 million less $2.3 million) representing additional commuter relief obtained from the State of New Jersey not reflected in 1965-66 results. 330 I. C. C. at 813-14.

of the merged system on specified terms. The day after the public announcement, N&W told EL that the terms of the Dereco plan were not negotiable but were "take it or leave it".* EL S-1, Fuller, at 18-19; Tr. 1568 [Pevler, N&W President].

The terms proposed by N&W were not fair to EL and not negotiable and the offer was conditioned upon a number of events beyond the control of EL and N&W, including Commission approval of an N&W-C&O merger. Therefore, on September 28, 1965, EL petitioned to reopen the N&W-NKP merger proceeding to hear and determine EL's application for immediate inclusion in N&W. Hearings were held before Commissioner Charles A. Webb between April 20 and August 10, 1966, and a recommended report and order was issued by Commissioner Webb on December 22, 1966. A final report and order was issued by the Commission dated June 9, 1967, 330 I. C. C. 780, followed by a supplemental report and order dated August 10, 1967. 331 I. C. C. 22. The principal findings and conclusions of the Commission with respect to EL are set forth at pages 14-16 of EL's Brief Below.

THE QUESTIONS PRESENTED ARE NOT SUBSTANTIAL

The EL Bondholders now claim to seek "protection of their vital interests." Jurisdictional Statement in No. 836, at 5. However, they have never stated what those vital

*N&W valued its 1965 offer to EL's stockholders at $43.4 million. Tr. 1288, 1623. Under the terms for inclusion set by the Commission, EL's stockholders will be given 648,777 shares of a nondividend-paying stock convertible into dividend-paying N&W common on a share-for-share basis at the end of five years. N&W common stock is currently selling at $91 per share. N. Y. Times, Nov. 25, 1967, at 60. Even if EL's stockholders were receiving N&W common directly, under the Commission's order they would receive only about $59 million (648,777 x $91). N&W's financial expert testified that nondividend-paying shares convertible into N&W common after five years would sell for 15% to 20% less than N&W common. Tr. 1656-58.

interests are, how they will or may be infringed or what, if anything, the Commission ought to do or ought to have done to protect them—except they now claim that the Commission ought now to retain jurisdiction to accord the EL Bondholders some relief from something in the future. Their present posture is consistent with their posture before the district court and their last-minute appearance before the Commission.* We note that the EL Bondholders do not seek delay in the inclusion of EL in the N&W system, *id.* at 3, and we are content to rely upon EL's Brief Below at pages 60-64 and the decision of the district court.

N&W presents seven questions. In essence, those questions were presented to and rejected by the court below. The EL Brief Below deals with the arguments presented there and repeated here. Since that brief is before this Court, we will not repeat our arguments.

The questions argued in N&W's Jurisdictional Statement in No. 779 (J. S. 779) are somewhat confusing. Thus, the first point in N&W's argument is "The Commission has not found that any public interest would be served by directing N&W to acquire the stock of deficit railroads." J. S. 779, at 10. That contention is quite true, and quite irrelevant, for the simple reason that the Commission has not directed N&W to acquire the stock of any railroad which it found to be a "deficit railroad."

Further, point 3 of N&W's argument curiously criticizes the district court for allegedly failing to follow the rule of *SEC* v. *Chenery Corp.*, 332 U. S. 194 (1947). The district court's statement that

> "... In *Massachusetts Trustees* v. *United States*, 377 U. S. 235, 248 (1964), the Court made plain that *SEC* v. *Chenery Corp.*, 318 U. S. 80 (1943), so

*The EL Bondholders did not participate in any way in the hearings before Commissioner Webb.

> heavily relied on by N & W, was intended only to establish the important point that a reviewing court could not affirm an agency on a principle the agency might not embrace—not to require the tedious process of administrative adjudication and judicial review to be needlessly dragged out while court and agency engage in a nigh endless game of battledore and shuttlecock with respect to subsidiary findings." J. S. 779, at B-69.

and its treatment of the issues are consistent with this Court's two decisions in *Chenery*. Compare for example that statement of the district court with the statement of Mr. Justice Black, dissenting in the first *Chenery* case (and in the majority in the second *Chenery* case):

> ". . . A judicial requirement of circumstantially detailed findings as the price of court approval can bog the administrative power in a quagmire of minutiae. Hypercritical exactions as to findings can provide a handy but an almost invisible glideway enabling courts to pass 'from the narrow confines of law into the more spacious domain of policy.' *Phelps Dodge Corp.* v. *Labor Board,* 313 U. S. 177, 194." *SEC* v. *Chenery Corp.*, 318 U. S. 80, 99 (1943).

Compare also this Court's first decision in *Chenery,* 318 U. S. 80, 87-88 (1943), with the statement of the court below criticized by N&W. The Court's summary of its first decision in *Chenery* in the opinion in the second *Chenery* case, 332 U. S. 194 (1947), relied on by N&W is not to the contrary.

In addition to relying on EL's Brief Below, we believe it may be useful to the Court if we attempt here briefly to point out two of the basic fallacies in the attack made by N&W on the decisions of the Commission and the court below.

I.

N&W'S ATTACK UPON THE COMMISSION'S DETERMINATION OF THE STOCK EXCHANGE RATIO FOR EL IS PREMISED UPON A FUNDAMENTAL MISCONCEPTION.

The illusion which N&W's basic argument seeks to create is that the Commission mechanically computed that EL would have net income of $9.6 million annually after inclusion in N&W and on that basis alone concluded that the prescribed exchange ratio was equitable. N&W thus would credit that $9.6 million figure with both a precision and a significance which it does not have.

EL's net income as projected by the Commission is not the product of a mathematical computation which, when compared with the projected earnings of N&W, produces the exchange ratio found to be equitable by the Commission. The projected net income for EL is a judgment by the Commission representing the resolution of many disputed questions concerning individual elements of value.* Some of those disputes were resolved in favor of EL and some were resolved in favor of N&W. As we shall show, the $9.6 million projection is most conservative. It reasonably could have been substantially higher.

Not only was the $9.6 million figure arrived at through the repeated application of judgment to a number of disputed issues, but its significance must be appraised in the proper context. The proper context includes: (1) the substantial discounting of the projected EL earnings made by the Commission in arriving at the prescribed exchange

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*"The valuation of railroad properties involves the application of informed judgment to many factors incapable of precise measurement. No mathematical formula is available; no scientific accuracy can be expected." *Pennsylvania R. R.—Merger—New York Central R. R.*, F. D. No. 21989, mimeo decision dated November 16, 1967, at 17.

ratio; and (2) the complete downside cushion of EL's earnings to which the Commission gave great weight, stating "even if EL earnings are not sufficient to support the proposed stock exchange ratios, N&W's investment is protected . . . [by] substantial tax benefits." 330 I. C. C. at 816.

As the district court pointed out, J. S. 779, at B-50, and as we described in EL's Brief Below at page 20, in projecting normal earnings for EL the Commission adjusted EL's actual 1965-66 earnings both up and down for a number of factors which were vigorously contested by both sides. Among the downward adjustments were $5.5 million of charges which cannot possibly occur for five years. 330 I. C. C. at 812, 845. Moreover, the Commission did not include in the $9.6 million projection the undisputed $1 million in annual tax savings that EL will contribute to N&W. *Id.* at 813-14, 846.

Having projected net income for EL in that conservative fashion, the Commission next calculated an exchange ratio of 0.172 of a share of N&W common stock for each share of EL stock. *Id.* at 815-16. However, the ratio set by the Commission was not 0.172 to 1 but 0.128 to 1—a reduction of 25%. In addition, the Commission, over EL's exception, further reduced the value of the exchange by providing that the exchange would not be EL stock for N&W stock but rather EL stock for stock of a new corporation (NC). 331 I. C. C. at 44-45. NC stock is convertible into N&W stock on a share-for-share basis after five years.* The Commission found that during those five years there is virtually no chance that EL stockholders will receive any dividends. 330 I. C. C. at 841-42. N&W's financial expert

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*Conversion may take place sooner if an amendment to the Internal Revenue Code first proposed in 1965, known as the Keogh Bill, is enacted.

testified that such shares would sell for 15 to 20 percent less than N&W common stock. Tr. 1656-58.

Moreover, the Commission did not justify the terms prescribed for EL solely in terms of its conservatively stated, sharply discounted judgment as to EL's future average net income as part of the N&W system. The Commission stated that "even if EL earnings are not sufficient to support the proposed stock exchange ratios, N&W's investment is protected . . . [by] substantial tax benefits." 330 I. C. C. at 816. N&W took no exception to the detailed findings in the recommended report on the tax benefits which EL will contribute. The Commission adopted Commissioner Webb's recommended findings *in toto*. *Ibid.* Those tax benefits are so large that they not only provide immediate significant benefits, *id.* at 846, but they also constitute a complete insurance policy to N&W for the investment it will make in EL. *Id.* at 847. Thus, as we demonstrated before the Commission and at pages 24-25 of EL's Brief Below, even if EL's future annual net income were zero, N&W would still recover its total investment through the tax benefits which N&W will obtain from the inclusion of EL.

N&W's feigned surprise at being told that it can, if necessary, "recoup the enforced purchase price from the United States Treasury," J. S. 779, at 11, comes with little grace at this late stage. The magnitude of EL's tax benefits have long been known to and, in fact, conceded by N&W. Indeed, those tax benefits were a major part of the motivation for the N&W-C&O merger proposal and the side offer to include EL. Exhibit EL-142 contains a secret memorandum* prepared by N&W's Senior Vice President and read by N&W's President to the N&W Board as the only support for management's recommendation of the N&W-

*The memorandum was not submitted by N&W but was obtained by EL from the record of an unrelated court proceeding.

C&O proposal. Tr. 1284-87, 1298. That memorandum reveals that acquisition of the so-called "Dereco" roads, of which EL is by far the largest, "would mean that for a number of years after the effective date of the affiliation, the N&W would have to pay little, if any, taxes." 330 I. C. C. at 847.*

In summary, as the district court stated, "we cannot emphasize too strongly that the Commission's exchange ratios represented an informed judgment on all elements of value rather than a mere mathematical calculation from some of them." J. S. 779, at B-50-51.

II.

THE COMMISSION HAS FOUND, AT LEAST TWICE, THAT EL SHOULD BE INCLUDED IN N&W ON THE PRESCRIBED TERMS EVEN IF D&H AND B&M ARE NOT INCLUDED.

N&W asserts that the Commission has made no finding with respect to whether EL alone should be included in N&W. Moreover, says N&W, if EL alone is included its value to N&W would be substantially reduced. N&W's first argument is flatly wrong, and its second is contrary to the evidence of record. Furthermore, both

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*The entire memorandum is reproduced as an Appendix to this motion. The important admission quoted above appears in the following context:

> ". . . Inclusion of these [five Dereco] subsidiaries gives the N&W the benefit of substantial tax losses. In addition, some of these subsidiaries [including EL, Tr. 1293] which are not now on accelerated depreciation can be put on accelerated depreciation and the tax benefit derived by the N&W. This would mean that for a number of years after the effective date of the affiliation, the N&W would have to pay little, if any, taxes.
>
> "At a minimum, the N&W would be able to reduce its taxable income by between $150 and $200 million over a five-year period. That would increase net income by about $75 million to $100 million over that period, or $1 to $1.25 per share per year." Appendix at 8a.

arguments depend upon N&W's speculation that neither B&M nor D&H will in fact be included in the N&W system, which is simply N&W's attempt to churn rumors into a basis for judicial decision.

N&W states "the Commission has never considered whether such inclusion [of EL alone in N&W], on the terms prescribed, is either in the public interest or equitable to N&W." J. S. 779, at 18. In fact, the Commission has twice found that EL alone should be included. The Commission's report and order expressly finds that N&W should be required to include EL whether or not D&H and B&M are included. 330 I. C. C. at 828, 868. On reconsideration, N&W urged at page 25 of its August 1, 1967, reply to the petitions of D&H, B&M and others that "all of the evidence of record relating to traffic gains and savings, and the Commission's findings with respect to the public interest, are based upon the explicit premise that all three of the petitioning railroads will be included." In its August 10 report on reconsideration, the Commission specifically repudiated N&W's contention in unambiguous language, stating "we disagree with N&W's assertion that inclusion of all three petitioners explicitly premises our decision herein." 331 I. C. C. at 41. The Commission then repeated its finding that EL alone should be included whether or not D&H and B&M are included. *Id.* at 43, 45. Those statements by the Commission dispose of N&W's first contention.

N&W also claims that "EL's viability would be severely curtailed if B&M or B&M and D&H were either no longer viable or allied with Penn-Central." J. S. 779, at 16. There is no evidence to support, or suggest, that conclusion.* In-

*N&W distorts the record, as it tried to do below, see N&W reply brief below at 19-20, when it attempts to promote EL's earlier testimony in the Penn-Central *Merger* case, that EL as an independent might lose $44 million in revenue as a result of a Penn-Central

deed all of the evidence directly supports the opposite conclusion. We demonstrate in EL's Brief Below at pages 40-43 that the record establishes that whether or not D&H and B&M are included will have little effect upon the amount of traffic which N&W and EL are able to reroute for their benefit. EL submitted two-way traffic studies to show the gain to the N&W-EL system that would result from two-way control. Ex. EL-101; EL S-7, Wyer, at 61-62. D&H and B&M also presented two-way studies which demonstrated their inability to reroute traffic away from EL. Ex. B&M-52; Ex. D&H-3d. Those studies are discussed in EL's Brief Below at pages 40-43. N&W presented three traffic witnesses who dealt at great length with the traffic patterns

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merger, into some kind of evidence that EL as a subsidiary of the N&W system would lose the same amount to Penn-Central. J. S. 779, at 22-23. As the district court pointed out, J. S. 779, at B-60, EL's traffic witness Schmidt made clear in this record that he did not make any study of the traffic EL as a subsidiary of N&W might lose to Penn-Central and he never expressed any opinion on that subject. Tr. 408. Schmidt was well aware that the hearing examiners at page 374 of their report served March 29, 1965, in the Penn-Central *Merger* case rejected Schmidt's 1962 study of the impact of Penn-Central on an independent EL as "highly exaggerated." EL S-6, Schmidt, at 19. Schmidt also testified in this record that the substantial improvements in service, car supply and operating efficiency of EL between the time of his 1962 study in the *Merger* case and his 1966 testimony here had made EL better able to compete and hence its traffic was far less susceptible to diversion in 1966 than it had been in 1962. *Ibid.*

It is also worth pointing out that N&W conceded toward the end of the hearings that cross-examination of Schmidt had failed to produce anything "helpful in a numerical way" with respect to the alleged loss to Penn-Central by EL as a subsidiary of N&W. Tr. 3276. Because N&W felt that "we had no dollar figure for the losses to Penn-Central under control" in the record, Tr. 3275, N&W undertook to present its own estimate of those losses through its witness McMichael (Ex. N&W-52); N&W stated that "we rely on that figure as to the extent of the control loss." Tr. 3277. That evidence dealt entirely with the losses under four-way control. N&W never submitted any estimate of the traffic which might be lost to Penn-Central if EL alone were controlled by N&W.

which would result from an N&W system including all three petitioners. Ex. N&W-13, McGohan; Ex. N&W-14, Fitzpatrick; Exs. N&W-15 and N&W-52, McMichael. However, N&W did not submit any evidence attempting to demonstrate what the traffic results of an N&W-EL system, without D&H or B&M, would be. Rather N&W relied specifically on N&W witness McMichael's estimate of loss to Penn-Central based on an analysis of an N&W system including all three petitioners. Tr. 3277.

N&W's speculation that D&H and B&M may, after all this time and effort, elect not to become a part of N&W appears highly exaggerated. The inclusion of D&H in N&W seems assured. D&H does not challenge the terms fixed by the Commission and its Board of Directors has voted unanimously to recommend to its stockholders acceptance of the terms proposed by the Commission. If B&M should elect not to be included in N&W, there are two possible alternatives. First, B&M may remain independent. If that possibility occurs, there will be no significant impact on EL or N&W. Second, B&M may reach an agreement with Penn-Central. Of course, the Commission may or may not find such a proposal to be in the public interest. If the Commission should do so, however, it would also have the duty to impose protective conditions upon a Penn-Central-B&M system in favor of an N&W system which established the need for such conditions. Interstate Commerce Act, § 5(2)(b). Clearly, if any such problem arises in the future, that is the time to be concerned about solving it; not now when there is no record even to support any concern about the existence of such a problem.

Finally, even if N&W were correct about D&H and B&M, neither the public interest in inclusion of EL in N&W nor EL's value to N&W would be affected.

CONCLUSION

There being no substantial questions presented, the judgment of the court below should be affirmed.

November 27, 1967.

Respectfully submitted,

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MEMORANDUM READ BY PRESIDENT OF N&W TO ITS BOARD OF DIRECTORS ON AUGUST 31, 1965*

For consideration by the Board, we have worked out a plan under which the C&O would be merged into the N&W, and we would offer to include in our system on specified terms five other major Eastern railroads: Erie Lackawanna, Delaware and Hudson, Boston and Maine, Reading and Central of New Jersey. The system, when consummated, would be substantially the same size as the proposed PRR-NYC system. The C&O Board is meeting in Cleveland now to consider this proposal.

According to the plan, C&O and N&W would merge on the basis of .725 share of N&W common stock for each outstanding share of C&O common. Each company would have equal representation on the Board of the surviving company. N&W-C&O would offer to take in the other five railroads as follows:

N&W-C&O would form a subsidiary, tentatively called Dereco. They would obtain all of the outstanding common stock of Dereco, which would amount to slightly more than 80% of the voting stock, in exchange for N&W-C&O stock and $6 million in cash. The N&W-C&O stock would be used in connection with acquisition of the Delaware and Hudson, and the cash would be used for working capital.

Dereco would then form five wholly owned subsidiaries having names substantially similar to the five railroads to be acquired and into which the five railroads would be merged.

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*It was solely upon the basis of this memorandum, contained in Ex. EL-142, that on August 31, 1965, the N&W Board of Directors approved the N&W-C&O Dereco proposal, Tr. 1287, 1298, under which EL's stockholders would have received stock valued by N&W at more than $43 million. Tr. 1288, 1623.

Delaware and Hudson Company would be merged into Delaware and Hudson Railway, a new company, on the basis of .25 share of N&W-C&O common for each outstanding share of Delaware and Hudson Company common.

Erie Lackawanna Railroad would be merged into Erie Lackawanna Railway, a new company, on the basis of .225 share of Dereco "A" stock for each share of Erie Lackawanna Railroad preferred and .065 share of Dereco "B" stock for each share of Erie Lackawanna Railroad common.

Reading Company would be merged into Reading Railway Company, a new company, on the basis of .15 share of Dereco "A" stock for each share of Reading first preferred, .075 share of Dereco "A" and .075 share of Dereco "B" stock for each share of Reading second preferred and .15 share of Dereco "B" stock for each share of Reading Company common.

Central Railroad Company of New Jersey would be merged into Central Railway Company of New Jersey, a new company, on the basis of .15 share of Dereco "B" stock for each share of Central Railroad Company of New Jersey common.

Boston and Maine Corporation would be merged into Boston and Maine Railway Company, a new company, on the basis of .175 share of Dereco "A" stock for each share of Boston and Maine Corporation preferred and .10 share of Dereco "B" stock for each share of Boston and Maine Corporation common.

There would be issued approximately 220,000 shares of Dereco Class "A" stock, which would have a stated value of $130 a share. It would have priority in liquidation in an amount equal to stated value and priority to noncumulative dividends over Dereco Class "B" and common stock in the amount of $5.20 per share. It would be convertible five years after issuance into N&W-C&O common on a share-for-share basis. It would be callable at $150 after six years if not converted.

There would be issued approximately 669,000 shares of Dereco Class "B" stock, which would be subordinated to Class "A" stock. It would have a stated value of $130 a share. It would have priority in liquidation over Dereco common in an amount equal to stated value and priority to noncumulative dividends in the amount of $5.20 per share. Like Dereco Class "A", it would be convertible five years after issuance into N&W-C&O common on a share-for-share basis and would be callable at $150 after six years if not converted.

Dereco common stock with a stated value of $32.50 per share would be subordinated to both Class "A" and Class "B" stock. After dividends on both those classes in the amount of $5.20 per share in any year, the common stock would be entitled to dividends at the rate of $1.30 per share. Any additional annual dividends would be shared between Class "A", Class "B" and common shares in relation to their respective stated values.

N&W and C&O plan to file with the ICC on or before November 1, 1965, an application for authority to merge. In the application, N&W and C&O would offer to accept as a condition of their merger the requirement that they offer to include the Erie Lackawanna, Delaware and Hudson, Boston and Maine, Reading and Central of New Jersey on the above-described terms, provided that:

(1) Present federal tax law is modified to permit the N&W-C&O to obtain the benefit of the tax carry-forward losses of the four loss companies (Erie Lackawanna, Boston and Maine, Reading and Central of New Jersey). A bill has been introduced into Congress by Representative Keogh of New York (H. R. 10542) to achieve this purpose.

(2) A permanent solution is found to the commuter problem of the Central of New Jersey, Reading and

Erie Lackawanna which would relieve these railroads of any losses in performing this service.

(3) There is no substantial adverse change in the financial position of any of the five subsidiaries.

There are compelling reasons for our affiliation with the C&O. At the present time, we have a favorable competitive situation in the territory we serve. There are now four major systems in the East. Measured by gross revenues, we have 18.3% of the market for rail traffic, C&O-B&O has 26.4%, PRR 31.2% and NYC 24.1%. While we are the smallest of the four systems, our location and traffic consist would permit us to compete on favorable terms if there are no further affiliations.

But if the PRR merges with the NYC and takes in the New Haven, it will have 57.0% of the gross revenues of the three systems, C&O-B&O will have 25.4% and we will have 17.6%. PRR-NYC will obviously be the dominant system in the East. We will be the only system without north-south routes between New England, New York and the south. We will serve only one port, Norfolk, which is the least important of the North Atlantic ports insofar as general cargo is concerned. PRR-NYC will serve all ports from Norfolk to Boston, and C&O-B&O will serve all ports from Norfolk to New York. Our competitive position would be substantially impaired.

If PRR and NYC merge, we could react by affiliating with the EL, D&H and B&M, and the C&O-B&O would, in all probability, eventually take over the Reading and Central of New Jersey. If that occurrred, we would have 24.1% of the gross revenues, C&O-B&O would have 26.1% and PRR-NYC 49.8%. PRR-NYC would still be the dominant railroad. While we would get into New York and Boston, it would be a high price, and we would

still have no north-south routes to compete with either the C&O-B&O or PRR-NYC.

From offensive and defensive standpoints, affiliation with the C&O now offers an attractive alternative in view of these prospective developments. Basically, it would create a strong system of even greater size than the PRR-NYC system. It would produce substantial financial benefits which would more than offset the price we would have to pay in taking in the financially weak companies, which would have to be done in order to obtain ICC approval and to produce two major railroad systems in the East. If this occurred, the N&W-C&O system would have 50.2% of the gross revenues and PRR-NYC 49.8%.

If this project is to be attempted, it must be done now. An undertaking of this size and scope, which requires a major change in the course railroad mergers have been taking in the East, presents a number of problems. However, we believe we have a reasonable chance of success. In essence, our point would be that merger of the N&W and C&O offers the only way of saving a number of railroads in the East and that it would provide a better balanced system than the three-party system previously contemplated.

As a practical matter, we think that if the PRR-NYC merger goes through, the N&W-C&O merger would have a good chance of going through, and, conversely, if the N&W-C&O merger were denied, there is a good chance that the PRR-NYC merger would be denied also. In either event, we would be better off than if we permitted the PRR-NYC merger to go through and had to face the decision of either taking in the EL, D&H and B&M or trying to compete on the basis of our present system.

Under our proposed plan, N&W's financial commitment will be firmly protected. If the Dereco subsidiaries, or any

of them, fail, N&W will have recovered its investment through the loss carry-forwards, which aggregate some $200 million. Assuming relief from only 75% of their commuter losses and merger savings of about $21 million realizable over a period of five years, our studies indicate that the total cash earnings (pretax) from the B&M, EL, CNJ and Reading subsidiaries would range from $4.7 million after the first year following affiliation to $29.4 million after the fifth year. This would be in addition to about $8.5 million of cash earnings from the D&H based on 1964.

In working out the exchange ratio of .725 with the C&O, we were aided by the investment banking firm of R. W. Pressprich & Co. of New York. They are of the opinion that the deal is fair and equitable to both sides. On the basis of current reported earnings and stock prices, the C&O stockholder would get a substantial premium. On 8/13/65 N&W common sold at 130 and C&O at 70. This would produce an exchange ratio of .54. On the basis of 1964 earnings after tax of $8.52 and $4.86, an exchange ratio of .57 would be justified. On the basis of 1965 estimated net income of $9.25 to $9.50 for the N&W and $4.93 for the C&O, an exchange ratio of .52 or .53 would be produced.

On the other hand, C&O owns about 90% of the B&O's stock and 63% of the Western Maryland's stock, but its share of the earnings of these companies is not reflected in C&O's reported earnings. If the C&O's share of these earnings had been included in its 1964 report, C&O would have shown earnings of $5.80 which would have produced a ratio of .68. This would have meant pro forma net income for the new N&W of $8.31 a share, or a reduction of N&W's earnings of 21 cents a share. To make up this difference, the new N&W would have to increase its earnings by $3.3 million by merger savings or otherwise.

However, B&O's accounts are not strictly comparable to those of C&O and N&W because B&O has obtained most of its equipment through lease from a subsidiary of the C&O. In effect, therefore, B&O is charging as an expense a part of the cost of its equipment which both N&W and C&O capitalize and charge against depreciation over a longer period of years. If adjustment were made for this difference, B&O's 1964 earnings would have been increased by $4.4 million and C&O's consolidated earnings would have been $6.30. This would produce an exchange ratio of .74. On this basis, the pro forma earnings of the new N&W would have been $8.59 in 1964 as compared with a reported $8.52.

It is estimated that the consolidated earnings for C&O-B&O-WM for 1965, on an unadjusted basis, will range between $6.49 and $6.70. Assuming earnings of the N&W between $9.25 and $9.50, we reach an exchange ratio of .68 to .724. Assuming the higher earnings of $9.50 for the N&W and the lower earnings of $6.49 for the C&O, we get pro forma net income of $9.28 a share, or a dilution of 22 cents a share, or $3.4 million. Assuming the lower earnings of $9.25 for the N&W and higher earnings of $6.70 for the C&O, we get no dilution.

On an adjusted basis, the C&O-B&O-WM's earnings are estimated at $7.00 to $7.21, which produces exchange ratios of .74 to .78. On this basis, therefore, in all cases there would be an increment to the N&W's earnings, ranging between 6 cents and 28 cents a share.

In sum, there are many statistical yardsticks which can be used to justify the .725 exchange ratio, some of which produce much higher ratios and some much lower. In this instance, however, we do not have to rely upon any projected savings. We simply have to give recognition to the C&O's ownership of B&O and Western Maryland stock

and make an adjustment in the B&O's reported income to put the figures on a comparable basis. The enormous benefits from the merger resulting from both savings and additional business will then flow to the stockholders of both companies on the basis of their ownership of the new company (59.56% to the N&W and 40.44% to the C&O).

The merger of the C&O into the N&W is not only attractive from the standpoint of the stockholders of both companies, but the inclusion of the other railroads through subsidiaries makes the deal even more attractive. Inclusion of these subsidiaries gives the N&W the benefit of substantial tax losses. In addition, some of these subsidiaries which are not now on accelerated depreciation can be put on accelerated depreciation and the tax benefit derived by the N&W. This would mean that for a number of years after the effective date of the affiliation, the N&W would have to pay little, if any, taxes.

At a minimum, the N&W would be able to reduce its taxable income by between $150 million and $200 million over a five-year period. This would increase net income by about $75 million to $100 million over that period, or $1 to $1.25 per share per year. Net income could be further increased by any savings realized and by any increased business generated by the new system. On the basis of projections which we have made in conjunction with R. W. Pressprich, we can visualize pretax net income in the $18 per share range as compared with $11.82 which the N&W earned in 1964. This projection does not take into account any new business which the expanded system could develop.

Is the proposed plan fair to the present stockholders of the proposed subsidiaries? The present D&H stockholders would get N&W stock on a basis related to earnings and present stock market prices. They now have a dividend-paying stock and will get a dividend-paying stock. The stock-

holders of the CNJ, Reading EL and B&M have not received dividends for a number of years. We propose to give them what is, in effect, a non-cumulative preferred stock (Class "A" or Class "B") of Dereco. It is unlikely that Dereco would pay any dividends to these stockholders during the first five-year period, although each class would be preferred as to dividends over the common stockholders. What makes the Dereco's Class "A" and Class "B" stock attractive is its right to be converted on a share-for-share basis for N&W common after five years.

This right, which is in substance a call on N&W stock, would have a current market value closely related to the present value of the outstanding stock of the proposed subsidiary. R. W. Pressprich believes this is a fair proposal. It not only gives these stockholders an immediate market value but a participation in what we reasonably expect to be the improved earnings and market price of N&W common.